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THE INTERPERIOD ALLOCATION OF INCOME TAXES

BY

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The undersigned certify that they have read, and recommend to the Faculty of Graduate Studies for acceptance, a thesis entitled THE INTERPERIOD ALLOCATION OF INCOME TAXES, submitted by Robert S. Kergan, in partial fulfilment of the requirements for the degree of Master of Business Administration.

ABSTRACT

The following is the logical argument of this thesis:

If the social sciences require evaluative ideas to give empirical data significance;
and
If accounting is considered to be a social science;
Then accounting requires evaluative ideas or a point of view.
If the measurement of income is accounting data;
Then the measurement of income will be determined by a point of view.
If income tax is considered to be a component of measured income;
Then the method of reporting income tax is determined by a point of view and the particular measurement of income utilized.

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CHAPTER I

PURPOSE AND SCOPE OF STUDY

Introduction to the Problem

For Canadians, income tax became a reality with the Income War Tax Act in 1917. As the name implies, this act was introduced as a temporary measure to pay for wartime expenditures. The act was retained between the two world wars and during the Second World War. Finally, with the appearance of the Income Tax Act in 1949, the taxation of individual and corporate incomes appears to have become a major and permanent part of Canada's fiscal system.

Accountants have been concerned with the problems associated with the reporting of corporate income tax in financial statements since the tax was first imposed. The traditional method of reporting was to recognize the tax at the time the liability arose. Recently, the increasing size and materiality of the corporate income tax charge has caused the accounting profession to reconsider this method.

The contention of this thesis is that the accounting profession has not adequately answered the income tax reporting problem. The inadequacy of the answers given by the professional accounting organizations results from a very limited concept of acceptable methodology. Accounting has for too long followed a very narrow inductive method in determining "generally accepted accounting principles."

A deductive process can be useful for accounting and is used throughout this thesis. The reason for using this process (rather than induction) is to break the traditional barrier now surrounding the development of accounting practice.

The methodology of this thesis is to establish several points of view which can be applicable for users of financial reports. From the criteria of the users needs, income measurements are selected. Based on both the point of view and income measurement, methods for reporting income taxes are established.

The Problem

The calculation of accounting and taxable income differ. Some differences are permanent and create no accounting problem. Other differences are

timing differences and these do create an accounting problem. Timing differences are brought about by revenues and expenses which are included in accounting income being reported in an earlier or later year in computing taxable income. These timing differences create problems for the establishment of the income tax expense for a given year. Should the tax be the actual liability calculated in the tax return or should the tax expense follow the financial reporting of the income components which created the tax liability?

> If components of taxable and pretax accounting income differ only because certain revenues are never taxable and certain expenses are never deductible, the tax computed in the current year's income tax return is the same as income tax expense. Likewise, if components of taxable and pretax accounting income fall in the same period, the income tax expense related to annual accounting income is the same as the income tax calculated in the tax return for the year. The income tax payable for a year frequently, however, does not represent the ultimate tax consequences of the transactions recognized in the financial statements for that year. [1]

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1 Homer A. Black, Interperiod Allocation of Corporate Income Taxes (New York: A.I.C.P.A., 1966), pp. 1,2.

Timing differences are the prime reason for the tax consequences not being reflected by the tax payable as calculated in the tax return.

A research committee of the Canadian Institute of Chartered Accountants made the following recommendations in 1968.

> In financial statements drawn up for submission to shareholders, corporate taxes are, for practical purposes, considered to be a cost incurred in the process of earning the income attributable to their shareholdings.
>
> A basic concept in the accounting measurement of income is that costs incurred in the process of earning income should be charged in the period in which the related revenues are reflected in the accounts. In the case of income taxes, the problem is one of selecting the basis for computing the tax charge which can be appropriately related to the income reflected in the accounts. [2]

The Canadian Research Committee quoted above then concludes

> That the tax allocation basis provides the most satisfactory method of achieving the prime objective of a proper matching of costs and revenues in the case of tax timing differences. [3]

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2 "Corporate Income Taxes" in C.I.C.A. Handbook (Toronto: C.I.C.A., 1968), p. 1941.

3 C.I.C.A. Handbook, p. 1944.

> ...(and) that the deferral method is the preferable method of applying the tax allocation basis. 4

The acceptance of the deferral method of tax allocation would mean for financial reports; (1) income tax would be an expense which would follow the income components which created the tax liability; and (2) the tax liability would not reflect future changes in tax rates.

The Canadian Institute's Research Committee report has conclusions similar to an opinion by the Accounting principles Board of the American Institute of Certified Public Accountants. The Accounting Principles Board's recommendations follow.

> (a) Interperiod tax allocation is an integral part of the determination of income tax expenses, and income tax expense should include the tax effects of revenue and expense transactions included in the determination of pretax accounting income.
>
> (b) Interperiod tax allocation should follow the deferred method, both in the manner in which tax effects are initially recognized and in the manner in which deferred taxes are amortized in future periods. 5

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4 C.I.C.A. Handbook, p. 1945.

5 A.I.C.P.A., "Accounting for Taxes" in Opinions of The Accounting Principles Board (New York: A.I.C.P.A., 1967), p. 158.

The above conclusions were reached even though the study which initiated the Accounting Principles Board's pronouncement included the following statement on the current status of financial reporting of income tax.

> The study does not answer fundamental questions about the nature of the income tax and the validity of the concept of interperiod income tax allocation. Whether income taxes are conceptually expenses or distributions of income has not really been resolved by the profession. Similarly, whether taxes should be allocated or whether the taxes currently payable should be the income tax expense for a period has never been adequately studied. 6

The study continues to justify its own findings with the following reason.

> Developments ... have gone beyond the fundamental questions. The factual stituation is that income tax allocation has been accepted, and most accountants and businessmen now concede the need for income tax allocation in at least some instances. The question is no longer allocation versus nonallocation but a little allocation versus a lot of allocation. 7

Justification of tax allocation based on acceptance and use does not seem to be sufficient. Some of the fundamental questions have to be answered.

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6 Black, Income Taxes, p. vii.

7 Black, Income Taxes, pp. vii, viii.

Many problems for accounting practice have resulted because the most basic questions have never been fully answered. In the words of Howard Ross, which follow, the basic issue seems to be that there is no purposeful direction.

> I am worried about something ... basic. The fact is that I am confused and in doubt as to the purpose of the whole system of financial reporting on which so much ingenuity and hard thinking have been lavished. Precisely what are we supposed to be accomplishing by issuing financial statements?
>
> Once granted there is a defensible and explicable purpose in financial reporting, I can see that everything else follows - deferred tax accruals, standard costs, depreciation of fixed assets, negative goodwill, capitalization of lease-purchase contracts and all the rest of it. Once over the main hurdle, these present no special difficulty. 8

Some of the basic issues for accounting are basic for reporting income taxes. Chapter II of this thesis examines some of these problems. What is accounting? What is the purpose of accounting? How can a definition and purpose be related to financial reports? These are fundamental questions which should be answered before any accounting practices are formulated.

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8 Howard Ross, The Elusive Art of Accounting (New York: The Ronald Press Company, 1966), pp. vii, viii.

The remainder of this study, therefore, attempts to develop a theoretical framework from which the interperiod allocation of income taxes may be evaluated.

Methodology

The following is the logical argument of this thesis:

> If the social sciences require evaluative ideas to give empirical data significance;
>
> and
>
> If accounting is considered to be a social science;
>
> Then accounting requires evaluative ideas or a point of view.
>
> If the measurement of income is accounting data;
>
> Then the measurement of income will be determined by a point of view.
>
> If income tax is considered to be a component of measured income;
>
> Then the method of reporting income tax is determined by a point of view and the particular measurement of income utilized.

The methodology of Max Weber is discussed in Chapter II. The theme which Weber develops is that empirical data must be related to evaluative ideas to give it significance. Accounting data is empirical in nature. Accounting needs to be related to evaluative ideas.

The value judgments in accounting are those of the readers of financial reports. This gives accounting a point of view and this is Weber's theme for the development of empirical research in the social sciences.

Chapter III of this thesis examines income theory. The chapter begins with a description of various concepts of income and their relationships. Next, the problems of utilizing these concepts in a practical way are examined. Finally, based on the points of view developed in Chapter II, specific measurements of income are selected for various readers of financial statements. The selection of measurements is limited by practical considerations.

The final chapter deals with the income tax timing differences which create the accounting reporting problem and the intent of the Canadian Income

Tax Act. These considerations along with the points of view developed in Chapter II and the concepts of income developed in Chapter III are used to determine methods of reporting income taxes.

Limitations of the Study

The methodology employed in this study is primarily deductive. This process has inherent weaknesses which result from faulty or incomplete objectives. Also, a deductive process may result in conclusions which do not have empirical validity. These weaknesses are accepted for this study.

Much has already been written in the development of accounting theory. This study will limit itself to the utilization of that which has already received partial approval as a theory in accounting literature.

The scope of this study will also be limited to consideration of the problem in Canada and only for external reporting in this country. For purposes of the legal framework the Income Tax Act as it relates to the year 1969 will be used.

Major Conclusions

Income tax as a component of measured income can be reported in many ways. The method for reporting income taxes in financial statements can be determined by the point of view of the reader and specifically the point of view which accepts or rejects a particular measurement of income.

The accounting profession must accept different criteria for evaluating and determining "generally accepted accounting principles." The circular logic currently employed by the profession restricts the development of new accounting techniques. A professional accountant cannot utilize a reporting method until it is "generally accepted." General acceptance, though, is evaluated through the criteria of utilization.

The development of accounting within the role of decision making is currently required by the profession. Decisions are related to the future. Accounting is historical in nature, but does not have to be only historical. Predictions of the

future are required for decision making and accounting can be used for prediction. Better predictions would be possible if the accounting profession would incorporate different reporting methods into generally acceptable methods. Accountants can and should accept the role of prediction.

CHAPTER II

ACCOUNTING THEORY

The Search for a Purpose

An analogy to the present method used in deriving "accounting principles" would be a situation such as one in which a foreman in charge of blowing a whistle to discharge workers from a plant phones a telephone operator for the correct time, only to find the telephone operator using the whistle to set her own watch. The determination of that which constitutes accounting theory and practice follows the same circular logic that the determination of time between the foreman and operator follows.

> (In accounting there) exists no useable criterion for testing either theory or application except that someone wants to produce a certain result. Unless and until the idea is tried, it cannot be accepted, and the fact that it is tried is often sufficient to cause acceptance under the present system of selecting accounting theory. 1

Accounting theory lacks internal logic. There exists no acceptable terms of reference for

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1 Delmer P. Hylton, "Current Trends in Accounting Theory", The Accounting Review, XXXVII (January, 1962), p. 24.

validation except that certain procedures are being used and therefore must serve some useful purpose. "Accounting has evolved ... as accountants have devised techniques and methods for performance of tasks at hand. For this reason, accounting has been greatly influenced by tradition and expediency." 2

The traditional methodology for accounting should not be the only way to develop "generally accepted accounting principles". The development of a currently satisfactory solution to the financial reporting problem of income tax requires a new approach. The approach of this chapter of the thesis will be to: (1) Establish the importance of evaluative ideas for a social science; (2) Explain how the evaluative ideas are used and are useful for the collection and interpretation of data; (3) Explain and define accounting as a social science; (4) Outline the evaluative ideas which may apply to accounting; and (5) Illustrate the current applicability of evaluative ideas from accounting literature.

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2 Frank J. Imke, "Relationships in Accounting Theory", The Accounting Review, XLI (April, 1966), p. 318.

The evaluative ideas (outlined in this chapter) establish several points of view for accounting. These are elaborated on and used in Chapter III to select measurements of income which would apply to a particular point of view. The combination of the points of view and income measurements are used in Chapter IV to establish methods for reporting income taxes.

To the extent that accounting theory has evolved with no basic theoretical direction, an examination of the methodology of another area of inquiry may be useful. The rest of this chapter deals with the methodology of the social sciences as developed by Max Weber. Particularily his use of the "ideal type " and a point of view are examined. This methodology is then used to give a theoretical direction to accounting.

METHODOLOGY OF THE SOCIAL SCIENCES

One of the first steps required in the development of any discipline is to define what the discipline is. This is not to say that disciplines are not interrelated or that investigation of the area can take place in a complete vacuum. Sociology has been defined as "a science which attempts the interpretive understanding of social action in order thereby to arrive at a causal explanation of its course and effects." [3]

Action included in the above definition would include all human behaviour to which the acting individual attaches "subjective meaning" and by virtue of this subjective meaning takes into account the behaviour of others and is thereby oriented in its course. [4]

> Processes or conditions, whether they are animate or inanimate, human or non-human, are devoid of (subjective) meaning in so far as they cannot be related to an intended purpose. That is to say they are devoid

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3 Max Weber, The Theory of Social and Economic Organization (New York: The Free Press, 1964), p.88.

4 Weber, Economic Organization, p.88.

> of meaning if they cannot be related to action in the role of means or ends, but constitute only the stimulus, the favouring or hindering circumstances. 5

The definition of sociology along with the other concepts, (meaningful human action) lead sociology into the field, not of individual action, but group action or behaviour. Thereby sociology becomes a study of culture and its organizations.

A purpose for sociology can now be derived.

> Sociology should show the plainly relativistic character of organizations and demonstrate that any one organization is only one form among many and can never claim a value superiority on scientific grounds ... Sociology ought to be of assistance ... Not that sociology should preach about the goals of human evolution or of one's own activities, but rather sociology could say: If you want this form of organization, then under given conditions, you must choose such and such means; further, when you use these means under economic, foreign policy, or other conditions, then, in addition to the sociological consequences that you want, such and such side-effects of a sociological nature occur. 6

So sociology has two purposes. One is a negative purpose in realizing the limits of knowledge

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5 Weber, Economic Organization, p. 93

6 Paul Honigshiem, On Max Weber (New York: The Free Press, 1968), p. 133.

and thereby not entering into the unresolvable field of aesthetics and values. The empirical approach, though, should be positive to the extent that this approach can be used as a tool for human beings to attain their given goals once these goals or ends are known.

A problem for sociology presents itself when trying to remain neutral and objective while still dealing with human values inherent in studying culture.

Neutrality and Methodology

To remain ethically neutral an investigator has to avoid confusion between factual judgments and value judgments.

> Even such simple questions as the extent to which an end should sanction unavoidable means, or the extent to which undesired repercussions should be taken into consideration or how conflicts between several concretely conflicting ends are to be arbitrated are entirely matters of choice or compromise. There is no (rational or empirical scientific) procedure of any kind whatsoever which can provide us with a decision here ... No one will dispute the idea that a certain end may be commonly agreed on, while only the means of attaining it are discussed. Nor will anyone deny that

> this procedure can result in a discussion which is resolved in a strictly empirical fashion. 7

The work of an investigator can remain neutral if the investigation is only to validate particular means to a given end as only the means could be validated. Validation of the end requires a value judgment and is outside the realm of verifiable knowledge.

Objectivity and Methodology

> There is no absolutely "objective" scientific analysis of culture - or put more narrowly but certainly not essentially differently for our purposes - of "social phenomena" independent of special "one sided" view-points according to which - expressly or tacitly, consciously or unconsciously - they are selected analyzed and organized for expository purposes. The reasons for this be in the character of the cognitive goal of all research in social science which seeks to transcend the purely formal treatment of the legal or conventional norms regulating social life. 8

The aim of the social sciences is to understand the uniqueness of reality. This aim would include the understanding of the relationships in their present sense and on the causes which makes

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7 Max Weber, The Methodology of the Social Sciences (New York: The Free Press) 1968, p. 133.

8 Weber, Methodology, p. 42.

them historically so and not otherwise. If infinite reality is to be understood by the finite human mind, then only a finite portion of reality can constitute the objective of scientific investigation and only this is significant or "worthy of being known".

The significance of cultural events presuppose a value-orientation. The concept of culture is itself a value-concept. Any investigation must have some perceptions of meaningfulness, as this must be presupposed before something becomes the object of investigation. Only by having some presupposition of significance can some order be understood from the chaos of reality, in that only part of reality is of interest or of significance to us. The significance of a cultural event is decided upon according to the value idea with which we view culture. Therefore, all knowledge of a cultural reality is a knowledge from a particular point of view.

> Accordingly cultural science in our sense involves "subjective" presuppositions insofar as it concerns itself only with those components of reality which have some relationship, however indirect to

> events to which we attach cultural significance ... Undoubtedly all evaluative ideas are subjective ... but it obviously does not follow from this that research in the cultural sciences can only have results which are "subjective" in the sense that they are valid for one person and not for others.9

Value Judgments

Value judgments do have a useful place for the empiricist although all that can be done using these judgments is to evaluate the means and possibly discover the repercussions and competition among numerous possible value judgments. Philosophical disciplines can go further and give meaning to the evaluations within the total "ultimate" evaluation. For the empiricist, far from being meaningless, value judgments and discussions can be of utility as long as their potentialities are correctly understood.

> Value judgments can have ... the following functions:
>
> (a) The elaboration and explication of the internally "consistent" value-axioms, from which the divergent attitudes are derived ...

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9 Weber, Methodology, p. 82.

(b) The deduction of "implications" ... which follow from certain irreducible value-axioms, when practical evaluation of factual situations is based on these axioms alone ...

(c) The determination of the factual consequences which the realization of a certain practical evaluation must have. 10

In order to carry out the above functions, the empiricist must use as an investigating device the normatively valid truths of philosophy or ethics transformed into conventionally valid opinions. All intellectual activities, including mathematics and logic, are subject to this transformation when normative truths are examined empirically. For example, to be able to understand an "incorrect" mathematical calculation or an "incorrect" logical assertion, and to analyze its consequences, reference must be made to the accepted "correct" calculation or "correct" logical assertion and the point at which the deviation takes place is understood by reference to the "correct" method.

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10 Weber, Methodology, pp. 20-21.

Therefore

> for purpose of the causal imputation of empirical events, we need the rational, empirical-technical and logical constructions, which help us to understand the question (of what a) .... thought pattern .... would be like if it possessed completely rational, empirical and logical "correctness" and "consistency". 11

These models represent "ideal types", such as the "capitalist", and, as such, act as a heuristic tool for an empirical investigator. This tool, although it may be constructed of questionable philosophical or ethical values, is immaterial in that the investigator is not validating the correctness of the model, but only using this construction to explain behavioural patterns. Rationality or irrationality is only evaluated as behaviour which conforms or does not conform to the model. The model, being considered as the "correct" mode of behaviour to reach a given end, is not to be questioned and thereby the investigator can achieve ethical neutrality.

The analytical accentuation of certain elements of reality can be justified for the social

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11 Weber, Methodology, p. 42

sciences. The "ideal type" is just such a formation which is a one-sided accentutation of one or more points of view which can be used as a heuristic conceptual tool.

The prejudices of this tool are not to be identified as historically natural prejudice. For example:

> Marxian "laws" and developmental constructs - insofar as they are theoretically sound - are ideal types. The eminent, indeed unique, heuristic significance of these ideal types, when they are used for the assessment of reality is known to everyone who has ever employed Marxian concepts and hypotheses. Similarly, their perniciousness so soon as they are thought of as empirically valid or real ... "effective forces", "tendencies", etc. is likewise known to those who have used them. 12

The objectivity of the social sciences, then, will be in its ability to use these scientific constructions, which are neither empirical reality nor reproductions of it, but only analytical tools. These constructions, by necessity, are based upon evaluative ideas which are empirically discoverable but cannot be empirically validated. The objectivity lies in the ability to relate empirical

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12 Weber, Methodology, p. 103.

data to thes evaluative ideas and it is this process which will give empirical data its significance. 13

ACCOUNTING AS A SOCIAL SCIENCE

Littleton recognized the following elements as being antecedent to the development of accounting: (1) the art of writing; (2) arithmetic; (3) private property; (4) money; (5) credit; (6) commerce and (7) capital. Writing and arithmetic are of course essential to the bookkeeping function. Bookkeeping is usually concerned with facts about property and rights to this property with money acting as the common denominator for the arithmetical function. Credit, commerce and capital would act as motivating forces in order that records of some sort be kept. The varying degree of rights to property that would so develop as business volume grows would also act as a motivating force. 14

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13 Weber, Methodology, p. 111.

14 A.C. Littleton, Essays on Accountancy (Urbana, Illinois: University of Illinois Press, 1961), pp. 4-5.

> "But indispensable though they are, even these elements could not produce bookkeeping by merely appearing together historically. All of them were present in some form throughout the era of ancient history, but the ancient civilizations failed to produce double entry." 15

The development of double entry, according to Littleton had to wait until the concept of "productive capital" was more fully developed. 16

Within the antecedent elements developed by Littleton a reason for accounting is not yet complete.

> The nature and placement of accounting can be seen more fully if we look at it as an active factor in modern industrial society. The widening use of accounting has definite social explanations and social consequences. 17

Accounting has become an information service of a special kind. Development began in aiding owner-managers of business enterprises through classification of facts about transactions. In time this function has expanded into a complex

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15 Littleton, Essays, p.5.

16 Littleton, Essays, p.6.

17 A.C. Littleton, Structure of Accounting Theory (Ann Arbor, Michigan: American Accounting Association, 1953), p.14.

set of instructions to aid in the internal control of large organizations. 18

Accounting statements also tell of the accountability of management, particularly corporate management for property placed under management control by third parties. This would include:

> their responsibility for the proper use of money borrowed under a liability; for costs incurred and the dividends declared. Accounting information also affords a basis for determining governmental revenue .... Clearly accounting is an important means of communication in modern industrial society. 19

The social sciences generally have been held to be concerned with

> the actualities of human societies in development .... with records of past actualities, with knowledge, with thought, and with methods of acquiring knowledge respecting the actualities of human societies in development .... 20 The social sciences are primarily concerned with those manifestations of human nature and those activities within society which involve social consequences and relations .... and with the inter-relationships

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18 A.C. Littleton, Structure, p. 14.

19 A.C. Littleton, Structure, p. 15.

20 Charles A. Beard, The Nature of the Social Sciences (New York: Charles Scribner's Sons, 1934), p.4.

> which accompany the functioning of society as a whole. 21

Accounting can be seen fitting into the concern of social science. Private property or the right to some control over certain property can be seen as a social relationship in that a person's or a group of persons' right of control is "envisaged as a right against some person or group of persons". 22 This right of control is also a relationship between the controlling person or persons and the object of control and is a social relationship which does have social consequences.

Money, credit and commerce are also items of social significance. Commerce is the prime social relationship with money and credit facilitating this relationship. Accounting as an information source is also a facilitating device to a social relationship.

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21 Beard, Nature of Social, p.11.

22 Louis Goldberg, An Inquiry into the Nature of Accounting (Menasha, Wisconsin: American Accounting Association, 1965), p. 40.

A Definition for Accounting

Accountants have not reached any general agreement on a definition for accounting. Definitions of accounting have been enunciated from Littleton's narrow concept of equating accounting to the measurement of income, to an all encompassing definition that accounting is useful. Within the more restricted definition, income, are definitional problems. Which concept of income is to be used? The more all encompassing definition of "useful" does have greater definitional problems, but immediately proposes the problems of usefulness to whom and for what purposes.

Some definitions, or what could be considered the objectives of accounting, follow.

> The distinction between capital and income .... is fundamental in accounting. Making effective and effectively maintaining as near as may be the distinction between capital and income of a particular enterprise are the ultimate objectives which determine the activities of accountants and the functions of accounting. 23

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23 Thomas Henry Sanders, Henry Rand Hatfield and Underhill Moore, A Statement of Accounting Principles (American Institute of Accountants, 1938), p. 1.

> Accounting is the art of recording, classifying, and summarizing in a significant manner and in terms of money, transactions and events which are, in part at least, of a financial character, and interpreting the results thereof. 24

> Accounting is the body of knowledge and functions concerning with systematic originating, authenticating, recording, classifying, processing, summarizing, analyzing, interpreting and supplying of dependable and significant information covering transactions and events which are, in part at least, of a financial character, required for the management and operation of an entity and for the reports that have to be submitted thereon to meet fiduciary and other responsibilities.25

> Accounting is a tool for use in the control of economic activity. It is a device for measuring and interpreting certain facts of an enterprise, meaning by "enterprise" any type of organization which deals with the manipulation of those social resources commonly called "economic goods". 26

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24 Paul Grady, Inventory of Generally Accepted Accounting Principles for Business Enterprises (New York: A.I.C.P.A., 1965), p.2.

25 Grady, Inventory, p.4.

26 C. Rufus Rorem and Harry D. Kerrigan, Accounting Method (New York: McGraw-Hill Book Company, Inc., 1942), p.3.

> Accounting is the art of recording and summarizing business transactions and of interpreting their effects on the affairs and activities of an economic unit. 27

The above definitions are functional definitions in that they attempt to illustrate what accountants in fact do or attempt to do. The function of classifying and processing of information could relate to almost any discipline. The functions of measuring and interpreting facts, transactions or events also could be related to almost any discipline. The definitions above are therefore discarded for the purpose of this thesis.

If accounting is a behavioural science then a behaviourial definition would better fit the needs of accounting. Earlier in this chapter, sociology was defined as "a science which attempts the interpretive understanding of social action in order thereby to arrive at a causal explanation of its course and effects". 28 Also, the social

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27 William W. Pyle and John Arch White, Fundamental Accounting Principles (Homewood, Illinois: Richard D. Irwin, Inc. 1959), p.1.

28 Weber, Economic Organization, p. 88.

sciences are "primarily concerned with those manifestations of human nature and those activities within society which involve social consequences and relations ... and with the inter-relationships which accompany the functioning of society as a whole". 29

Financial accounting is defined for purposes of this thesis as an art or science which attempts the interpretive understanding of the social action of the "relationship of ownership and / or use (or control) of property" 30 in order thereby to arrive at a causal explanation of this relationship and the resulting inter-relationships, as to their course and effects of social consequence.

> We do not, however, account for persons or things as such - that is the field of the medics, the psychiatrist, the physicist and chemist - but rather for certain relationships which are taken to exist between persons and between persons and things ... Relationships between individual persons and between individual persons

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29 Beard, Nature of Social, p. 11.

30 Goldberg, An Inquiry, p. 47.

> and individual things are the terms in which accounting standards and procedures are to be explained, and it is the nature of these relationships, which are .... human constructs, which have to be examined if we are to find a basis for accounting theory. 31

Property in this text is used in its most general context in that it could include non-material or non-tangible activities and services as well as tangible objects. 32

In other words accounting as a separate discipline included in the social sciences attempts to understand the relationship between people and the economic assets which people can control, that is, use for their own benefit. Any particular asset may benefit many people and each of these benefited persons will have varying degrees of control over the benefits which they personally will receive.

A Purpose for Accounting

This paper deals only with external accounting. The external persons which are generally held

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31 Goldberg, An Inquiry, pp. 37-38.

32 Goldberg, An Inquiry, p. 37.

to have some measure of control over business property, could be classified as follows. Primarily would be shareholders, other investors and creditors, and secondarily would be employees, customers and the public. 33 For purposes of simplicity, whether a person's or group of persons' control is an end in itself or a means to an end, all reasons for control will be considered to be ends in themselves. For example, a cash dividend paid to a shareholder is giving the shareholder a generalized means to attain some consumption which would be the end which the shareholder had in mind in purchasing his shareholding. The payment of the dividend will for the purposes of this paper be considered as an end in itself. Within these ends a purpose can be defined for accounting. For simplicity, another assumption will be that the parties mentioned above as having some control have no direct control over the property concerned but only some control over their relationship to them. For example, a bank

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33 See Eldon S. Hendriksen, Accounting Theory (Homewood, Illinois: Richard D. Irwin, Inc., 1965), p. 82 for further explanation.

may call a demand note, but does not have the right to write itself a cheque or sell assets to achieve collection of the note except possibly under extreme circumstances. Other parties can be seen in similar circumstances of being able to apply pressure on the managers of the assets but not being able to directly control the use of the assets. Even government with great dictatorial powers may prescribe the limits to which an industrial plant may pollute a particular river. The managers of the plant, though, will prescribe the methods used to reach the limits of pollution and may even close the plant to meet the requirements, if they so desire. The ability to alter the relationships will also determine the purpose for accounting.

The above assumptions (means are ends, no direct control of property) simplify the relationships described below. Also, the assumptions put the relationships in a more normal rather than an extreme circumstance.

THE RELATIONSHIPS

The business firm has varying relations with identifiable individuals and groups. Each of these individuals or groups will have a different point of view from which they will examine their relationship with the firm. This point of view is related to their own ends or the benefits which, they as an individual or a group, may derive from their association with the business firm. Also, any action taken by individuals or groups to alter their relationship with a firm is restricted through legal measures or practical considerations. Some of the benefits that may be desired by individuals or groups through their relationship with a firm along with restrictions placed on altering these relationships, are discussed below.

Shareholders and Other Investors

The usual reason for the purchasing of shares or other investments would be the postponement of current consumption (spending the money so

invested for some other purpose) for future benefits to be received such as dividend or interest payments, an increase in the money value of the investment and a return of the money invested. There may also be a desire for a regular as opposed to an erratic payment of these future benefits. Basically this could be described as a desire for income.

Shareholders and other investors have these alternatives for changing their relationship: (1) the purchase of a larger investment; (2) the sale of a portion of their investments; (3) maintaining their investment; and (4) bringing pressure to bear on the managers of the property to change the properties' uses. Potentially management could be removed but this would be brought about only in extreme circumstances.

Creditors

Credit is usually extended in the course of a sales contract. A creditor would therefore be most interested in continuing to sell and receive

payment within the time limits prescribed by the sales contract. There may also be a desire to sell in greater volume to the firm at higher prices.

Creditors may alter their relationship by (1) increasing the line of credit available; (2) decreasing the line of credit available; (3) refusing credit; and (4) possibly taking legal action to collect outstanding payments.

Employees

An employee may wish to have good working conditions which would include many interpersonal as well as physical requirements in the job which he holds. He may also be desirous of a "fair" wage on a continuing and long-term basis.

An employee can alter this relationship by: (1) staying at his job; (2) leaving his job; and (3) bargaining with management for changes, either as an individual or through a group such as a union.

Customers

Customers want to be sure that the price is not excessive for the quality of the product received.

Also, they may be interested in a continuing relationship of greater quality in products and reduced prices.

A customer has the alternatives for altering his relationship of: (1) buying the product in increased quantities; (2) buying the product in decreased quantities; (3) continuing to buy in the same quantities; and (4) possibly suggesting changes in the product.

The Public

Generally the public can be thought of as being represented by government and to the extent that a business firm acts within the legal framework and the general moral framework of a society, the public is not interested in altering its relationship with the business firm. The moral framework, though, may include continuing as an entity.

Government may alter its relationship through direct legislation and enforcement or through moral suasion.

Summary of Relations

Each of these particular groups of people require some type of summarized information which will basically tell them "Is the company in good shape now and in the future?" 34 But, each group has its own particular view of the preferred shape. Certainly there will be similarities in each interest group's requirements but each will require somewhat different information. This is because each group has different alternatives available to it in revising its relationship with the business firm and different criteria and objectives for evaluating which alternative to select.

A purpose for accounting can now be determined. The purpose of accounting is to identify, measure and communicate economic information to permit informed judgments and decisions by users of the information. 35

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34 Howard Ross, The Elusive Art of Accounting (New York: The Ronald Press Company, 1966), p. 32.

35 American Accounting Association, A Statement of Basic Accounting Theory (Evanston, Illinois: American Accounting Association, 1966), p. 1.

The processes of identifying and communicating are necessary if accounting is to be considered an information system of any kind. Measurement can be assumed from its least sophisticated circumstances to its most sophisticated. For example, a statement to the effect, "They found gold", could have had as much significance for accounting and the users of this information as a statistically developed trend line. Economic information is used only because accounting as a discipline is, for all practical purposes, still only struggling in this area. In other words accounting does not have to be limited to economic information, but will be for the purposes of this paper.

Inherent in the informed judgment and decision which accounting is supposed to permit is a point of view. A judgment has to be from a point of view because a judgment must be based on some set of values or the biases of a point of view. The decision, if it is based on the judgment, will necessarily reflect the judgment values and point of view.

POINTS OF VIEW IN ACCOUNTING

Accountants have generally accepted that accounting has at least two points of view, these being a management or internal point of view and an investor-creditor or external point of view. Other points of view are realized to exist, but in most instances are reflected in information only at the specific request of the parties who wish their point of view to be represented. Some of these other points of view are represented by government agencies and major creditors.

> The distinction between internal and external reporting would seem "simple and self evident". But, the general assumption until relatively recently was that one type of accounting could satisfy the needs of both management and of such "outsiders" as shareholders or creditors. 36

The question is now asked, are other points of view of a general nature possible and useful for accounting purposes?

Goldberg would answer emphatically "yes". In his words "The existence of a point of view is fundamental for accounting, the one thing often being

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36 Ross, The Elusive Art, p. 28.

regarded from different points of view with very different accounting results." [37]

An example would be land which is rented by the owner to a farmer. The relationship of the owner to the land is obviously ownership and the relationship of the farmer to the land is one of use. One item, rent, would be accounted for as revenue by the owner and as an expense by the farmer. [38] Information relating to an increased value of the land due to increasing urbanization of the rural area would probably be of no concern to the farmer, but could be of vital interest and concern to the owner.

Accounting is therefore held to have a point of view. The point of view being that of the person or persons receiving the accounting information. This point of view can probably be best represented by the potential alternative decisions available to these persons for altering their relationship with

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37 Goldberg, An Inquiry, p. 47.

38 Goldberg, An Inquiry, p. 48.

a business enterprise. Some points of view have been discussed in accounting literature and these points of view follow.

The Entity and Proprietary Points of View

The Proprietary viewpoint is that of owners. To the extent that a business may have more than one owner, the group of owners is considered to act as an association having similar goals. The assets and liabilities of the business are considered to be the owners assets and liabilities for accounting purposes and the balance sheet equation becomes "Assets - Liabilities = Proprietorship". The major purpose for accounting becomes one of determining the proprietors' equity and the changes therein. Income and retained earnings are considered to belong to and be for the benefit of the owners. 39

The Entity viewpoint is one of an impersonal being seeing the business as something separate and distinct particularly from those who contributed

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39 Arthur N. Lorig, "Some Basic Concept of Accounting and their Implications", The Accounting Review, XXXIX (July, 1964), pp. 564-65.

capital to it. The assets and liabilities are those of the entity and an extreme view would make the balance sheet equation "Assets = Equities". 40 Profits which are earned become the property of the entity and owners or shareholders have a right to these profits only if and when a dividend is declared. 41 The emphasis for accounting becomes one of social responsibility and concerns itself with all activities of the business in society and "reports back to the members of the society". 42

Both the Entity and Proprietary viewpoints have various shades of meaning. For example, the owners for a proprietary view may include long-term creditors as well as shareholders, or it may include only common shareholders. The entity viewpoint may include all expenditures including dividends as expenses or may recognize some payments as distributions of income rather than expenses.

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40 Lorig, "Basic Concepts", p. 567.

41 Reginald S. Gynther, "Accounting Concepts and Behaviourial Hypotheses", The Accounting Review, XLII (April, 1967), p.276.

42 Gynther, "Accounting Concepts", pp. 278 -79.

Other Points of View

The Proprietary and Entity points of view have been found wanting in some instances of accounting theory and practice. Other viewpoints have been attempted and two are presented here. These points of view are the Fund and the Commander points of view.

The Fund point of view is one of maintaining complete objectivity. Assets become service potentials for the fund and equities are viewed as restrictions on these assets. The balance sheet equation becomes Assets = Restrictions. Income as such is ignored and the residual change in net assets merely becomes a balancing figure for the fund. [43]

The Commander point of view may be illustrated by the following.

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43 William J. Vatter, The Fund Theory of Accounting and Its Implications for Financial Reports (Chicago: The University of Chicago Press, 1947), pp. 1-38. Due to the complexity and sometimes the logic of items placed on the credit side of the balance sheet Vatter seems to prefer the term "restrictions" in an attempt to classify all of the credit items similarly and not become involved in the previous problems of categorizing balance sheet credits as liabilities and ownership.

> In a corporation ... the functions of the commander and investor are sharply distinguished. The investor has command over his resources until he becomes a shareholder in a company; at that moment he transfers his command over a quantum of resources invested to those who have control over the affairs of the company, that is, to the directors and managers. He remains the owner of shares, that is, of certain (usually restricted) rights to participation in periodic distributions of the Company's "profits" and in the final distribution of assets; in this sense, he is a part owner of the company's resources, but he has no command over the resources which his shares purport to represent ....
>
> Once the position of the commander is recognized, it becomes clear that accounting functions are carried out for and on behalf of commanders. Accounting reports are reports by commanders to commanders ....
>
> Accounting thus becomes a matter chiefly of recording, reporting, analyzing and interpreting events relating to resources for the benefit of informing those people who are commanders of such resources ....
>
> In his fiduciary capacity ... the director must transpose his point of view to that of the investor. 44

Points of View in Accounting Conclusion

Practicing accountants recognize the need for at least two viewpoints (internal and external) to

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44 Goldberg, An Inquiry, pp. 164-69.

meet the needs of statement users. Theoretically, for financial reporting, two viewpoints are recognized (Entity and Proprietary). Different results for accounting are accepted for different points of view. More points of view should be included in the preparation of financial accounting statements. Special purpose statements are required so logical inconsistencies between points of view are avoided. This is one of the purposes behind the development of other points of view (Fund and Commander).

SUMMARY

> The same firm, i.e. the same set of facts can be seen in several different manners, which merely illustrates a matter that psychologists have been concerned with for many years. What is an "objective fact" is often only that which is perceived as being such by an individual. Each of us sees the world in a manner slightly different from the next one; many variations in perception are possible. 45

The above is merely a statement of a "truism". Different people have different perceptions of the world around them and the more complicated the thing that is viewed the more likely that the perceptions will be different. This chapter has examined the problems imposed by differing perceptions of the world on scientific investigation in the social sciences. This has been related to accounting.

Different perceptions or a point of view are not only real but can serve some purpose. They are real due to physical and other limitations of human beings and serve the purpose of serving these limitations. People cannot know everything about the world or even an individual object or event, but a

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45 Gynther, "Accounting Concepts", p. 280.

less than all encompassing knowledge about an object or event will enhance a person's knowledge or understanding of the thing.

So long as the quest for knowledge is just a curiosity seeking of the mind then the limited knowledge gained has no point of view. Once a reason is established for gaining knowledge then it has the point of view of the reason for the quest of knowledge. The reason gives meaning to the data or information which is gathered and this is particularly true for gaining some meaning for human activities. People are usually activated for some reason and the reason is usually based on some value judgment. Value judgments, then, can give meaning for human actions.

Value judgments can cause different perceptions to occur of human activities. This does not mean, though, that all perceptions are different, but, depending on the similarity in values held by various people, similar perception of human activities can occur.

For accounting a business firm can be viewed as having several points of view depending upon the values which various parties hold concerning their relationship with the firm. These different points of view have been recognized by accountants in dividing accounting problems into internal and external reporting. For external accounting development of theories depending upon an Entity point of view or a Proprietary point of view also illustrate the acceptance of a point of view.

Different accounting results can be determined by different points of view. 46 But, this does not necessarily mean that a particular accounting result determined by a particular point of view cannot have meaning for many people, that is "in the sense that they are valid for one person and not for others." 47 Accountants are generally skeptical of accepting several points of view for external reporting. Earlier in this century any point of view, even a fraudulent one,

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46 See Lorig,"Basic Concepts", p. 82.

47 Weber, Methodology, p. 82.

was being used for accounting purposes. This earlier exposure to many points of view does give accountants some perspective to the problems which can result from non-uniformity of practice, but does not invalidate the possibility of several points of view being objective and meaningful. This objectivity and meaningfulness to one group of persons does not necessarily mean that it is accomplished at the detriment of some other group or groups.

Some problems for accounting reporting have occurred due to different value judgments being applied to the same set of accounting facts. The result has been many practices being developed for the same set of facts and becoming "generally acceptable" for no apparent reason. A closer examination of the values assumed in developing accounting practice and setting these values up in a logical manner to indicate the complete thought pattern could serve the purpose of at least recognizing the reasons for inconsistencies in current practice.

For accounting this means that particular points of view based upon some system of values will have to be discovered for those parties interested in the firm. These values are empirically discoverable but cannot be validated as being "true" just as similar value systems are not for other disciplines. The objective for accounting, then, will be to relate accounting data to these evaluative ideas "and it is this process which will give empirical (accounting) data its significance."[48]

> For years managers were told that they should rely in running their business on guidance provided by statements prepared largely on principles designed to protect creditors and investors. On the other hand, investors have sometimes been persuaded they should be satisfied with data prepared partly on assumptions that were designed for those responsible for management decisions.[49]

Both a managerial and investor point of view are now recognized in accounting, although they sometimes become confused (i.e. Entity point of view). With the passage of time and the increasing size and importance of business enterprises more points

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48 Weber, Methodology, p. 111.

49 Ross, The Elusive Art, p. 28.

of view should be recognized. A changed point of view toward the investor from one of protection to one of guidance is required now. Recognition of more points of view and changed points of view could help accounting to gain in giving significant understanding to empirical data, this being one of its continuing problems.

The reporting of income tax in financial statements can be done in various ways. An acceptable method, though, should be based on the information which a reader of the statements may require. That is, the readers point of view. The acceptance of only one method for the reporting of income taxes is not necessary or desirable. Several methods should be accepted and used.

CHAPTER III

INCOME THEORY

The contention of this thesis is that depending upon the concept of income that is used, various methods for reporting income tax in financial statements can be determined. The concept of income used is determined by the value judgments of the users of the statements. The method for reporting income taxes is determined by the value judgments and the concept of income used.

Many concepts of income have been developed. Some of these concepts are discussed below. The conceptual scheme developed relates an individual concept of income to a more generalized system of measurement. The individual concept is an "ideal" measurement of income, but for practical reasons has to be discarded for accounting purposes. Other concepts of income have been developed to meet practical requirements and are available for accounting purposes. Accountants can and should use the measurements of income which have been developed to meet the practical problems of communicating information. Some of these concepts

are currently being used for internal reporting. Utilizing the same concepts for external reporting should not be difficult.

This chapter has the following plan.

(1) Concepts of income are introduced. The importance of income to the individual is related to the concepts which are measurable for external reporting.

(2) The problems of measurement are introduced to indicate the reasons the accounting profession should accept new measurements of income and possibly why it has not.

(3) The need for more specialized accounting reports is examined again, in light of A Behavioural Theory of the Firm (Cyert and March).

(4) The particular goals of some "external" participants of the business firm are examined and matched with a useable concept of income.

CONCEPTS OF INCOME

Society

Income is closely related to the satisfaction of human wants and / or desires. It is related to the "thirst ... for pleasure, for existence, and for prosperity". 1 Income is a means to an end and it appears to perform the following functions:

> (1) It is a means to gratify mankind's physiological requirements (food, clothing, shelter, medicine), and enables man to consider both present and anticipated future needs.
>
> (2) It is a means to satisfy the need for self-expression in the form of pursuit of noneconomic interests (religious, ethical, scientific, and esthetic).
>
> (3) It is a means to satisfy the need for social recognition (power, prestige, and popularity). 2

Wealth could also perform these functions so income and wealth are related. For the individual, income has been defined as "what he can consume during the week and still expect to be as well off

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1 Norton M. Bedford, Income Determination Theory: An Accounting Framework (Reading, Mass.: Addison-Wesley Publishing Company, Inc., 1965), p.11.

2 Bedford, Income, pp. 14-15.

at the end of the week as he was at the beginning". [3] Wealth then becomes a measure of well offness and income the change in wealth. Wealth in turn becomes a store of income. Not all changes in wealth, though, can be attributed to income. Some changes may be consumption of wealth or in accounting terminology a withdrawal of capital. Income would be the change in wealth that could be consumed.

The "thirst for pleasure" acts as a catalyst or motivating device for human activity. Because income can serve as a means to this end it becomes a motivation for human activity.

Psychic, Real and Money Income

The general societal concept of income could be referred to as "psychic" income. This would refer to a change in wealth which brings about or may potentially bring about the satisfaction of human wants. If there is some "true" individual concept

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3 J.R. Hicks, Value and Capital (Oxford: The Clarendon Press, 1939), pp. 176 -77, as quoted by Louis Goldberg, An Inquiry Into The Nature of Accounting (Menasha, Wisconsin: American Accounting Association, 1965), p. 247.

of income then this concept would be "psychic" income. A problem arises, though, in identifying a proper measure of psychic income. Different things will have varying degrees of want satisfaction for various people at any given time and varying degrees of want satisfaction for the same person as at various times. 4 For example, a hearty meal to a hungry man will satisfy a great want for him, but for a man who is not hungry the meal will have little value. Once the meal is eaten by the hungry man a similar meal would not immediately have the same want satisfying qualities that the first meal had. The same thing may have varying values at various times and for various people. The best that can be accomplished in measuring "psychic" income then is to find some approximation or average which may suffice.

One attempt at such an approximation is "real" income. Many psychic wants are satisfied by goods and services or economic values. So, the assumption may be made that an individual who gains

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4 Bedford, Income, pp. 20-21.

control over goods and services has at his disposal the means to satisfy a great many of his psychic wants. "Real" income refers to changes in economic wealth.

A further movement away from the concept of psychic income is made when a generalized unit of measurement is used. This unit of measurement may be utils or some other measuring unit. It is usually money or a monetary unit which presumably represents a generalized power to control the use of goods and services. A third concept of income is "money" income which refers to changes in the monetary evaluation of economic wealth. Here the assumption is made that money, exercising a generalized control over goods and services, acts as a good measuring unit for goods and services which in turn represent an approximation of psychic wealth or income.

Now we have three related concepts which are all approximations of a "true" income which would be represented by the general well being of an individual. This study though is only interested

in economic activity and for all intents and purposes it is most likely that the pursuit of real income, and its measured approximation money income, is that which motivates these activities.

Business Income

"Business" income derives its basic meaning from its capacity to satisfy individual wants, (i.e. psychic income). In some ways business income is more inclusive than psychic income as several individuals or groups can be identified as having an interest in the want satisfying power of a business. Also, business income is more exclusive as particular interests of individuals or groups can be identified. Business income could then be referred to as a change in wealth for the individuals or groups associated with a business firm and resulting from the relationship with the firm.

Business income in economic theory is held to be maximized or at least an attempt is made to maximize income. Profit maximization is maximizing

future profits and therefore lies in the area of expectations rather than reality, and is subjective in nature. 5

Subjective Income

"Subjective" income is the measurement of the expected dividend (usually cash) flow from a given group of assets. This is the measured income which is to be maximized. It is subjective in that agreement on its probable validity compared to actual future events is true only for one or at least a very small number of persons. Subjective income leads to a subjective value of the assets. This subjective value of the assets must exceed the more objective value of a market value of the assets, otherwise the assets will be sold or not purchased. The excess of subjective value over market value then is the criteria that is used for a choice among alternatives. 6

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5 Edgar O. Edwards and Philip W. Bell, The Theory and Measurement of Business Income, (Los Angeles: University of California Press, 1967), pp. 33-34.

6 Edwards and Bell, Business Income, pp. 37-38.

Realizable Income

Realizable income is the dividend flow that could be expected from a group of assets if these assets were liquidated at current market values. As market values are only a consensus or average of subjective values, realizable income becomes an approximation of subjective income. This approximation, though, becomes more objective than subjective income as a greater number of people would be willing to accept the validity of this measurement of potential future events.

Subjective value is a personal evaluation, and different managements will have different subjective values for the same resource. The interplay of these subjective values in the market place results in market value. In a somewhat vague sense, market value is an average of these subjective values of a particular resource or resources. [7]

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7 Bedford, Income, p. 28.

Realized Income

Realized income is the dividend flow that has actually been experienced from a group of assets usually through the sale of an asset or some other objective point of recognition. Realized income would most likely follow realizable income in time as the date of sale usually follows the date of saleability in time.

Realized income differs from realizable income in that realized income is computed by valuing unsold resources at cost, whereas, in computing realizable income, these same resources would be valued at the sales market value. 8

Concepts of Income Conclusion

Psychic income is an individualized concept of income and varies over time and with each individual. Real income does not specify a unit of measurement except in economics something called utilities may be used. For practical reasons (too much variability and lack of an adequate measuring unit) these concepts cannot currently be used for

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8 Bedford, Income, pp. 31-32.

accounting reports. Money income does offer a potentially useable concept. The unit of measurement is specified and it does not vary greatly by individuals. There are problems involved with the value of money changing over time, but some solutions are now being offered to accounting for this problem. Subjective, realizable and realized income can be closely specified methods of measuring money income. These three concepts could therefore be utilized in the measurement of money income. For purposes of this thesis subjective, realizable and realized income are selected for potentially useable concepts for the measurement of income.

The three concepts, although related, measure income for three different periods of time. Realized income is income currently earned. Realizable income is income which could currently be realized if assets are sold. Subjective income is the measurement of anticipated future realizable income. Subjective and realizable income thereby become predictors of realized income.

The concept of income which is currently acceptable to the accounting profession is realized income. The other two concepts should also be acceptable if a prediction is desired.

MEASUREMENT OF INCOME

> Accounting is a system for communicating the economic events of an entity. Communication is based primarily on quantitative information ... The economic events of an entity must be represented by an organized set of symbols which are suitable for communication. Furthermore, the representation must follow certain rules so that the economic events can be inferred from the symbols. 9

Business income is one of the prime measurements applied to the communication of economic events. Currently the measure is communicated in a quantitative style to persons both internal and external to a firm.

The Characteristics of a Unit of Measurement

A measurement will only describe one characteristic of a particular object such as its size or weight. Measurement will not tell us about other characteristics of the object unless it is used in conjunction with some other description or measure. For example, a particular object weighs 100 pounds. From this could be

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9 Yuji Ijiri, The Foundations of Accounting Measurement (Englewood Cliffs, New Jersey: Prentice-Hall, Inc., 1967), p.3.

inferred that if this were dropped it would create a loud noise. If this object happens to be a gaseous substance then the inference would be incorrect. But, if we also had a measurement of the volume a more correct inference could have been made as the density of the object (a third measurement) could have been calculated from the first two measures.

An exact measurement, that is the "true" state of the characteristic of the thing being measured, is rarely possible. This is due to inaccurate measuring devices and human error. Nevertheless, from a series of measurements we can develop a probability distribution of the "true" measure and gain greater insight through the probably "true" measurement. Therefore, in order to gain understanding of a particular object or thing, several characteristics should be measured and several measurements of the various characteristics should also be made.

Objectivity and Reliability

Objectivity in accounting measurement can be defined simply as "the consensus among a given group of observers or measurers". Objectivity is neither black nor white but varying shades of grey. For example, a group of accountants could most likely reach a consensus on the amount of money in a particular box at a given time but may have difficulty in reaching a consensus on an income figure for a particular business firm for a particular period of time. 10

An accounting measurement model could be represented by the following factors: "1) an object whose property is to be measured; 2) a measurement system which consists of a set of rules and instruments; and 3) a measurer." Variability in a consensus, then, can be caused by difficulty in identifying the object to be measured, a lowly specified system of rules and instruments and a poor measurer or a measurer who depends upon his

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10 Yuji Ijiri, The Foundations of Measurement, pp. 134-135.

own judgment due to difficulties in the system or object. 11

Accounting theorists have spent time developing a more highly specified system and to some extent, through definition, have developed better methods of identifying the objects to be measured. The development of trained measurers has been facilitated by professional accounting organizations and various other educational programs. The development of objectivity, though, has been hindered or possibly confused by the problem of the reliability of the measurement of accounting information.

In general, a system of measurement can be said to be reliable if it works in the manner in which it is supposed it should. For example, if the speedometer on a car actually measures the speed of the car then it is reliable. Reliability though can go further. For example, from one measurement, say the speed of a car, we may also wish to estimate the time that a journey will take or the

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11 Ijiri, The Foundations of Measurement, p. 135.

extent to which the driver abides by the laws of the land. The measurement of speed at a particular time may or may not reliably measure these outcomes of time and lawfulness. Accounting also has problems of reliability related to both the measurement of that which accountants purport to measure and the judgmental and decision making value of accounting measures in predicting other events.

Profit on a Venture

For accounting, at least historically, the venture is the basic activity which over a period of time gives rise to a profit or an income figure. "Single events do not themselves give rise to profit or loss; it is only when events are related to each other that a result can be determined." The simplest case of a business venture would be one in which goods are purchased for cash and subsequently sold for cash. If the cash available to the venture was greater after the sale than before the purchase, then a profit is the result (a reverse cash position would be a loss). "Hence we may say that a profit arises on a trading venture when on

the application of any satisfactory unit of measurement, the resources at the end of the venture are greater than they were at its beginning." 12

Periodic Gain

A business can be thought of as a venture in that it takes part in many purchases and many sales. Businesses, due to incorporation and other reasons, cover a time period of indeterminate length. Therefore an accounting of business ventures has become necessary which combines many ventures and for a specific period of time. This periodic accounting creates problems for the accounting measurement of profit.

When combining ventures into one business the discovery of a true profit for each individual venture usually becomes impossible. An example would be overhead costs in a manufacturing process. The use of direct costing merely "begs the question" concerned with answering the problem of allocating costs. In addition, the combination of ventures

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12 Louis Goldberg, An Inquiry Into the Nature of Accounting (Menasha, Wisconsin: American Accounting Association, 1965), pp. 235-236.

does not usually come to a final end during the period for which an accounting is being done. This results in the accounting profit for one period including ventures partially completed in previous periods and partially completed in the current period. If there are problems involved in allocating costs and revenues to a particular venture, then the problem just becomes that much more difficult when allocation must also be made to particular time periods.

Certain accounting procedures have been developed to allocate costs between ventures and time periods. To some extent these procedures have developed to serve various purposes. For example, direct costing is probably very useful for purposes of short run decisions related to the allocation of resources. The assumption in direct costing is made that certain costs are going to be incurred regardless of production or sales for a certain period of time. This assumption, though, is not as valid as the time period is expanded and includes the long run. In this case an absorption costing method may be more useful.

Measurement of Income Conclusion

Accountants have a strong tendency to use only "objective verifiable evidence" when measuring income. Although a measure may be objective this does not necessarily mean that it serves a purpose.

Greater emphasis in accounting needs to be placed on the reliability of a measure to serve a purpose. For example, a person may wish to know if a chair is comfortable. Informing this person that the chair has such and such dimension may help him to evaluate its comfort. Informing him that the chair is foam rubber filled would be more reliable for his evaluation, but a less objective measure.

Similarily, in accounting, if a person wishes to know something about future income, subjective or realizable income would be appropriate. Accountants, though, would only give the person a measurement of realized income.

In utilizing the concepts of subjective or realizable income accountants will run into problems which cannot currently be resolved. These problems,

though, should not be any more difficult than those unresolvable measurement problems encountered in using the concept of realizable income. These problems can be examined and some satisfactory solution determined. The use of direct costing for short-run decisions and absorption costing for longer term decisions is an example. The costing problem also illustrates the use of at least two viewpoints.

POINTS OF VIEW AND INCOME

Several points of view or organizational objectives are realized with the acceptance of A Behavioral Theory of The Firm as presented by Cyert and March.

> If we wish to develop a theory that predicts and explains business decision-making behavior, we face a problem that can be paraphrased in terms of the following:
>
> 1. People (i.e., individuals) have goals; collectives of people do not.
>
> 2. To define a theory of organizational decision making, we seem to need something analogous - at the organizational level - to individual goals at the individual level ... The theorist's problem is then to identify some concept of organization goals that is consistent with the apparent denial of their existence. Since (rightly or wrongly) individual goals are perceived as lodged in the individual human mind, the problem is to specify organizational goals without postulating an "organizational mind". 13
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> The view of an organization thus becomes one of a coalition of its members. The coalition being made up of individuals and some of these individuals being organized into subcoalitions. The members of a business organization coalition might "include

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13 Richard M. Cyert and James G. March, A Behavioral Theory of the Firm (Englewood Cliffs, New Jersey: Prentice-Hall, Inc., 1963), p.26.

> managers, workers, stockholders, suppliers, customers, lawyers, tax collectors, regulatory agencies, etc." . 14

The traditional approach to organizational goals is one which eliminates conflict through a consensus. One economic solution is to recognize organizational goals as the goals of the entrepreneur. Conformity to these goals by other members of the organization is purchased through wage, interest and other payments. In other words, the pursuit of organizational goals is internally consistent.

Since the existence of unresolved conflict is a conspicuous feature of organizations, it is exceedingly difficult to construct a useful positive theory of organizational decision making if we insist on internal goal consistency. As a result, recent theories of organization objectives describe goals as the result of a continuous bargaining-learning process. Such a process will not necessarily produce consistent goals. 15

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14 Cyert and March, A Behavioral Theory, p. 27.

15 Cyert and March, A Behavioral Theory, p. 28.

A theoretical interpretation of Cyert and March might be that the individuals involved with an organization bring with them their own goals based on their own system of values. Values or value judgments cannot be validated as being correct or true in the sense that they are true for everyone, but they are empirically discoverable. One of the problems for management scientists and accountants is to be able to relate empirical data to these evaluative ideas. This will give empirical data its significance (see Chapter II) and measured income is empirical data.

Derived Concepts of Income

Income in the above discussions in this chapter has been limited to a concept of benefits flowing from a group of assets. The problem, of to whom these benefits flow, has been ignored. The solution of this problem is one of the problems of a derived income concept. The problem can be seen in perspective using the concept of a coalition bargaining. Income can be seen as a fixed "booty" to be divided among the various participants. The "booty" does not necessarily have to

be fixed. For example, funds made available through income could be used to purchase an employee recreation center. The employees would consider this a benefit to themselves through use of recreation. Shareholders could consider the center as having benefits for themselves through contented employees working more diligently. For simplicity the "booty" will be considered to be fixed in amount.

Another assumption is that all parties included in the coalition would agree that income is one of the basic concepts of business income and is a flow of benefits from a given group of assets. Also, they would all agree that the benefits are not available for division until realized. So, the realized concept of business income becomes the focus of their attention. The other concepts of business income become the predictors of realized income. Therefore, if the purpose of measuring income is to divide the available income between coalition members a realized income is the important measure. If the purpose is to predict the future share of income between participants then realizable

or subjective income become the important measures. Rather than becoming involved in the controversial price level measurement concepts the assumption here will be made that income and its components are primarily economic in nature and can be measured by some monetary unit.

The examination of some of the coalition members view of income follows.

Shareholders

The decision which a shareholder must make is whether to buy, sell or hold shares in a particular business. He does this by comparing the investment he has or might have in the business with other uses which he may make of the resources utilized in the investment. Economically the benefits which can accrue directly from the investment in shares are dividends and a return of capital. A return of capital will be ignored here as this does not happen too frequently. A return of capital, though, may be obtained through the sale of shares to another person. This may be effected by the business by its maintaining registration for trading

on a recognized stock exchange. The actual payment of dividends is legally the discretionary power of the board of directors, but a measurement of income can indicate at least the limits of this power. So the measurement of income is a useful source of information for determining the potential benefits which a shareholder can expect to receive from a business. Dividends paid in an immediately proceeding period and some measure of realized income for a current period would probably, under normal circumstances be sufficient to predict dividends for the short-run. The real value of the investment, though, is in its potential to continually pay dividends. Therefore an income measurement with greater predictive power is necessary for shareholders. These measures would include realizable income and subjective income. A derived concept of income would include as deductions payments made to all other parties, (such as interest to creditors) would also be useful.

Creditors

Creditors generally would not have the same interest in income as shareholders. This stems

from the usual fixed contractual obligation that a business firm has with its creditors. A business firm that produces greater and greater amounts of income is only of interest to creditors in that the possibility of the fixed obligation being paid is increased. An increase in income would under usual circumstances not increase a creditors income. Therefore creditors only wish to know that their investment is secure. To evaluate the security for the future only major catastrophies need to be predicted. Income predictions for future periods would be useful for this purpose and the length of the prediction would depend on the length of time the investment arrangement was to exist. Normal trade creditors (30, 60 or 90 days) are probably more interested in the availability of cash than an income figure. As the time period increases, though, creditors will become interested in an income figure, but a more conservatively stated income figure than the shareholders. So if a subjective income figure is to be used for prediction a pessimistic subjective evaluation would be the

most desirable. A derived concept of income would be one that would include deductions for all expenditures including dividends as this would be the most conservative figure.

The creditors point of view toward income may be summarized as follows:

> The second financial statement a banker will want to evaluate when making a credit decision is the income statement. The importance of this statement to the banker in making his decision increases as the maturity of the loan requested increases. 16

The contrast between shareholders and creditors can be shown in the following:

> When analyzing the accounting data of companies requesting loans, we tend to emphasize the negative aspects ... When looking at common stocks, we are more interested in analyzing those factors which lead to growth in earnings since our decision to invest is formulated around a projected objective of compound annual return based on a combination of appreciation in price and dividend income. 17

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16 Alan K. Browne, "The Use of External Accounting Data In Decisions At the Bank of America", in The Use of Accounting Data in Decision Making, edited by Thomas J. Burns (Columbus, Ohio: The Ohio State University, 1967), p.83.

17 Frank J. Hoenemeger, "The Use of External Data in Decisions At the Prudential Insurance Company of America", in The Use of Accounting Data In Decision Making, edited by Thomas J. Burns (Columbus, Ohio: The Ohio State University, 1967), p.92.

So shareholders or potential shareholders are primarily interested in an income figure and more accurately a future income figure. Creditors are only interested in an income figure to the extent that the payment of interest is assured and to assure some growth in resources particularly cash resources so the principle of the loan can be repaid.

Employees

The closest to the true bargaining for a greater share of income would be employees. For employees the income figure that is currently used is one which would be the least conservative, attempting to show the highest possible profit along with the greatest growth in productivity.

> Wherever possible, the reported net income figures are adjusted to achieve an operating measure by elimination of nonoperating or nonrecurring items, income or expenses applicable to prior years' operations; charges or credits with respect to reserves for contingencies; and reserves to reduce Federal income taxes in future years, based on savings in current taxes resulting from accelerated depreciation and the investment credit. 18

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18 George Perkel, "The Use of External Accounting Data In Decisions At the Textile Workers Union of America", in The Use of Accounting Data In Decision Making, edited by Thomas J. Burns (Columbus, Ohio: The Ohio State University, 1967), p. 114.

So employees, as union members, would see an income figure for which they, as workers, could be held responsible. Recognition should be given to other participants requirements but only if they are currently payable. The employee attitude is perhaps a short-run attitude as wages tend to be paid on a regular basis and the immediate use of these wages is the concern of the employee. Also, the employees largest investment in a business firm can usually be withdrawn fairly painlessly. If a business fails then an employee offers his services to some other organization and recoupes his investment by working for someone else. A shareholder or lender cannot so easily remove his investment.

> The financial reports indicate to the Union Leader at best how well the Company has fared in the past. While they provide the basis for inferences about the future, there are too many additional factors to be taken into account to warrant the use of financial data by the Union Leader as a critical element in his calculations ... The situation in which a company's financial position plays a critical part in collective bargaining is in the nature of a special case where if a company claims "inability to pay" as grounds for exemption from a clearly established wage pattern. 19

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19 Perkel, "The Use of Accounting Data", pp. 115-116.

So employees as union members can be said to have a short-run pragmatic outlook toward a particular business and its measurements of income. They are more concerned with industry-wide and country-wide indications of income. Unions then, as representatives of employees, are interested in a realized concept of income, so their bargaining position cannot be undermined by subjective contemplations. Separating expenses and revenues that can be related directly to a cash source from those which are allocated in some arbitrary manner would be useful for unions. The latter derived concept is necessary for unions so such things as depreciation charges can be evaluated for their arbitrary and possible anti-union consequences. Also, a derived concept of income indicating the resources which caused expenditures would be useful for calculations of changes in productivity and the sources of these changes.

Community

The community in general terms would be interested in an income figure for purposes of "fairness"

to the community. That is, that excessive market control will not mean excessive profits nor that excessive competition will result in poor business practices or sudden closure of a major economic enterprise. The public or community would probably be interested in a realized concept of income and a derived concept of income which would be similar to the union concept of resource payments so some calculation of value added could be made.

Points of View and Income Summary

The coalition members discussed above would be interested in the following concepts of business income. Shareholders should have an interest in realized, realizable and subjective income. Creditors would be interested in a realized and realizable income measurements. Both these would be more conservatively stated for creditors than for shareholders. Employees would be interested in only a realized concept of income and a measurement process which would least conservatively state the income figure. The general public would be interested in a realized concept of income.

SUMMARY AND CONCLUSION

Income is a very important concept for society and accounting. Many concepts have been developed which are approximations of the change in wealth or well-offness known as income. Some of these concepts, such as psychic income, are only ideal concepts which for practical reasons will most likely never become useful in a practical sense. The other concepts, though, have been utilized some to a lesser extent (subjective income for internal management) and some to a greater extent (realized income for accountants and real income for economists). Any of the concepts which have been developed in a practical way are available for accounting use in financial reporting.

Some problems, regardless of the concept used, will develop due to the difficulties involved in any measurement technique. A "true" measure of anything is probably not possible, but in many cases an approximate measure is probably just as adequate as the "true" or exact measure. In accounting the emphasis has been on attempting to gain an objective

measure of accounting data. This places a constriction on accounting data in developing reliable measures which may be more useful in predicting other events or in gaining greater insight into the business for which an accounting is being made. Regardless of the objectivity or reliability of a measure there will always be some areas in accounting which can never be resolved because of allocation problems arising between ventures and periods of time. Regardless of the measurement problems the time has probably passed for which only an objectively determined accounting income figure can be considered the most useful for any purpose or all purposes that are supposedly inherent in financial reporting.

The emphasis of a particular point of view will determine a different measurement of income. This has been so in the development of income figures which are applicable to economics, accounting and taxation. For the financial reports developed by accountants this could be true for the various parties who presumably utilize this financial information and would include shareholders, creditors, employees

and the community. These parties all have or should have some interest in an income figure for a business firm. This interest will vary depending upon their values and their ability to control the action of a business firm or their relationship with the business firm. Different concepts of income will therefore be applicable to each of these groups and even when similar concepts are applicable different detailed analysis and biases will be applicable. Financial reports which present a single income figure which is supposed to satisfy all parties and all purposes for each party is probably impossible.

CHAPTER IV

THE PROBLEM REVISITED

INTRODUCTION

This chapter deals with the interperiod allocation of income taxes for financial reporting purposes in the following way: (1) The actual timing differences will be explained and examined to determine if there are any inherent differences caused by the differing components of timing differences; (2) The probable intent of the Canadian Income Tax Act will be examined to determine the bearing that the legal context may have on the reporting of income tax; (3) The more acceptable methods for handling the reporting of income taxes will be examined and these will be compared to the subjective, realizable and realized concepts of income to determine which, if any, reporting method would most properly fit a concept of income; and (4) The points of view of the parties for whom external accounting reports are made will be examined to determine the appropriate treatment for each of these groups of persons.

Income tax by name and usually by legal definition is related to some concept of income. This relationship has caused problems for financial reporting. Income tax has been classified in various ways at various times by accountants. Some of these concepts and perhaps all of the concepts of income tax are applicable to financial reporting. The contention of this thesis is that the applicability of each or any of the concepts will depend on a point of view and particularly the point of view which accepts or rejects a particular concept of income. Also the legal intention of an income tax will determine the concept of income tax which is applicable to financial reporting.

TAX TIMING DIFFERENCES

Tax timing differences may be classified in the following way:

> Reported for income taxes after recognized for accounting income
>
> (A) Revenues or gains are taxed after accrued for accounting purposes. These differences usually result from voluntary elections of the taxpayer.
>
> (B) Expenses or losses are deducted for tax purposes after accrued for accounting purposes. These differences usually result from requirements and interpretations of the tax laws.
>
> Reported for income taxes before recognized for accounting income
>
> (C) Revenues or gains are taxed before accrued for accounting purposes. These differences result from requirements and interpretations of the tax laws.
>
> (D) Expenses or losses are deducted for tax purposes before accrued for accounting purposes. Some of these differences result from voluntary elections of the taxpayer; others may result from requirements and interpretations of the tax laws. [1]

Whether an item is handled in a particular way because the taxpayer elects to do so or is required to do so by the tax law does not change the accounting

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1 Homer A. Black, Interperiod Allocation of Corporate Income Taxes (New York: American Institute of Certified Public Accountants, 1966), p.3

evaluation involved unless tax management is the purpose of the evaluation. An evaluation of the tax management of corporate managers is probably close to impossible without detailed knowledge of the corporate situation and taxation laws. The important differences for classification in accounting would relate to the known or the unknown nature of the impact on taxation of particular timing differences. The impact on taxation, that is the cost or saving for tax purposes that a revenue (gain) or expense (loss) has created, would be known for items already included in the calculation of income tax but excluded from the calculation of accounting income (items (C) and (D) above). The impact on taxation would not be known for items included in the calculation of accounting income and not yet included in the calculation of taxable income (items (A) and (B) above).

If the item is known, then an objective measure of the income tax impact can be made. If the effect of the timing difference is unknown then a less objective and at times speculative measure

of the future income tax implications can be made. The less objective measure is subject to change in accounting treatment over time as new information is known about the income tax effect of the item involved. Changes may take place in the Income Tax Act which could affect the timing of the item as well as the rate of taxation applicable. Also, changes over timing could take place due to inaccurate estimates or changed circumstances for the company. For the more objective measure of the impact, changes may occur in the accounting treatment of the item involved due to changes in the estimated time that the item is to be included in the calculation of accounting income. Both the known and the unknown impact of timing differences can be subject to changed accounting treatment, but the known impact items are less likely to change.

The likelihood of changing the accounting treatment of a tax timing difference may be of some benefit to a person utilizing financial statements.

Therefore some distinction should be made between tax timing differences that have been reported on tax returns and those that have not been reported. The former differences creating a speculative accounting figure and the latter a less speculative figure.

INTENT OF THE LAW

The presumed objective of the Canadian Income Tax Act is to supply revenues for government expenditures and to provide fiscal control of the economy. In this way income tax is similar to other tax levies. Ultimately the Canadian people in general pay any tax levied, but the intent of an income tax is to extract taxes from those sections of the economy most able to pay the tax. The problem for the interperiod allocation of income taxes is whether the intent of the Canadian government is to tax the corporation, the shareholders of the corporation, or some other party through its taxation provisions based on corporate earnings?

In Canada the intent of the government, as to whom it intends to tax through the Corporate Income Tax, is not entirely clear. A corporation, for example, is not allowed to deduct dividend payments. In turn the shareholders are not allowed the deduction of all the corporate income tax paid on income distributed by the corporation to them. A maximum of approximately 75% (for company earnings

below $35,000.00) and 20% (for company earnings above $35,000.00) is allowed. The intent of the Income Tax Act is not entirely clear as to whether the Corporate Income Tax is intended to tax corporations as an entity or act as a withholding tax paid for the benefit of the shareholders. In other words, does the Government of Canada view the corporation as a taxable entity. For this reason the assumption will be made that the intent of the Act is to tax the corporation. This assumption would make income tax an expense and subject to most accounting treatments of expenses, particularly allocation between periods. This assumption could be incorrect in the future. Fiscal controls may necessitate changes for the future. Also, consideration of new tax legislation (White Paper and Carter Report) indicate changes which could change the expense assumption.

METHODS OF ACCOUNTING FOR INCOME TAX

Although many methods of accounting for income taxes have been developed four methods will be considered here. The methods considered will be

(1) flow-through, (2) deferred, (3) liability, and (4) net of tax.

Flow-through

The assumption of the flow-through method of tax accounting is that the income tax expense for the year is the same as the amount of income tax assessed for the current year. This method of accounting for income taxes can vary slightly for "obvious" timing differences of a non-recurring nature.

Deferred

> The deferred concept emphasizes the effect of timing differences on income of the period in which they originate. The income tax expense is a function of pretax income (excluding permanent differences between accounting and taxable income) unless the expense is effected by amounts deferred previously at other than current rates. The primary purpose is to match the income tax expense with the items which cause a tax effect. 2

Liability

> The liability concept views tax allocation as accruing income tax expense as a function

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2 Black, Allocation of Income Taxes, pp. 13-14.

> of pretax income, excluding permanent differences between accounting and taxable income. The tax on all elements of pretax accounting income may not, however, be computed at the same rate. The difference between the current tax expense and the tax currently payable is either a liability for taxes payable in the future or an asset for prepaid taxes. The estimated amounts of future tax liabilities and prepaid taxes are computed at the tax rate expected to be in effect in the future periods in which the timing differences are reversed. [3]

Net of Tax

> The net of tax concept is based on the proposition that taxability and tax deductibility are factors in the valuation of individual assets and liabilities ... If the timing of a revenue or expense accrual differs for tax purposes as compared with accounting purposes, the tax effect is an adjustment of the specific revenue or expense and of the related asset or liability. Direct adjustment of revenue, expense, asset, or liability items is the customary practice, thereby showing net of tax amounts. [4]

The actual calculation of the tax allocated can follow either the deferred or liability method of calculation. [5]

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3 Black, Allocation of Income Taxes, p. 13.

4 Black, Allocation of Income Taxes, p. 14.

5 Black, Allocation of Income Taxes, p. 23.

The Methods Compared

The flow-through method (not allocating income taxes between periods) takes a very legalistic approach to accounting for income taxes. Unless and until the related asset or liability would be recognized by the Income Tax Act or related government department, financial statements should not, under most circumstances, recognize the liability (asset) or expense (revenue) for income taxes when following the flow-through method. The deferred method emphasizes the matching of revenues and expenses and would have us believe that income tax should be related to the corresponding components of the financial income statement. The liability method follows an emphasis similar to the deferred method except that, for the liability method, the liability (asset) which results from allocation should reflect changes or expected changes in tax rates. The deferred method would use the tax rates currently applicable and not adjust for future changes in the rates. The net of tax method adds little to the deferred or

liability methods except possibly for final presentation and for this reason will not be considered further for this thesis.

If allocation of income tax is found to be preferable from a particular point of view, then, either the deferred or liability method of allocation would be preferred. Due to the known or unknown nature of an item creating tax allocation (see Tax Timing Differences above) then one method of allocation may be preferred to another. The deferred method would be preferable to the liability method for known items as the liability concept would indicate that an evaluation of managerial tax management was being made, usually with hindsight. Also, the tax effect for known items is known in monetary terms. For the unknown items the liability method would seem more appropriate as the monetary effect for tax purposes is not known for the items involved.

SUBJECTIVE, REALIZABLE AND REALIZED INCOME

In chapter three subjective, realizable and realized income concepts were discussed. These currently seem to be the core of measured concepts

of income. If income tax is considered to be an expense then income tax becomes a component in calculating the measurement of these income concepts.

Following a strictly realized concept in measuring income a flow-through method of calculating the tax expense would be the most appropriate. The flow-through method is selected because this indicates the tax expense realized. Also, recurring items creating tax allocation problems can be shown to create a continuing asset or liability, the asset presumably creating no benefits and the liability never coming due. An example of a continuing liability would be a company which maintains a constant financial policy toward fixed asset investment and expenses fixed assets more quickly for tax purposes than it expenses fixed assets for financial reporting. Therefore the income tax liability or asset may never be realized in the foreseeable future.

For both the subjective and realizable concepts of income tax allocation using the deferred or liability method of calculation (see The Methods Compared above) would seem appropriate. Both of these concepts of income utilize a discounting

procedure in arriving at a measurement of income. The calculation of the tax allocation to be discounted would be the same for both concepts of income. The discount rate would also be the same as there only exists a subjective market evaluation for an asset or liability created by tax allocation. The tax timing differences, though, can be seen effecting future cash flows to a company and therefore a discounting procedure should be followed. Also, the subjective and realizable concepts of income allow speculation on future events so a tax allocation method should be permitted for an accounting measurement of these concepts.

EXTERNAL REPORTING

The financial statements of a corporation can be of interest to shareholders, creditors and employees of the corporations as well as the general public in its role as government or as prospective shareholders, creditors or employees. Each of these groups of people have been shown to have a different point of view for evaluating the corporation and the measurement of net income for the corporation. Income tax

is generally held to be a component to be included in the calculation of net income and therefore each of these groups can be held to have a different point of view toward income tax as it relates to the calculation of income for a corporation. The possible attitudes of the various groups to an accounting concept of income tax as it relates to the calculation of income for a corporation follow.

Shareholders

Shareholders were (see Chapter III) thought to be interested in two concepts of income: a realized and possibly a realizable or subjective measurement of income. If shareholders consider income tax to be an expense of the corporation then for a realized concept of income a flow-through method of reporting income taxes would be applicable. If a subjective or realizable concept of income is to be reported to shareholders then a discounted tax allocation method should be used.

Creditors

Creditors were maintained (see Chapter III) to be interested in similar concepts of income as

shareholders, except that creditors would want a more conservative measurement of income. Therefore, for creditors measurement of a realized concept of income would include allocated income taxes for items which created liabilities on the balance sheet of a corporation and no allocation for items which would create assets on the balance sheet. For a predictive measurement of income creditors would most likely be interested in a realizable concept of income and the income tax which would be included in this calculation would be the same as for the realized concept of income. Following the conservative attitude assumed for creditors, the above calculations would result in the largest possible tax expense being reported. Although conservatism in earlier years can cause the reverse effect in future years, for tax allocation this would mean that the timing differences are reversing themselves and being realized so a less conservative attitude would be applicable.

<u>Employees</u>

Employees were held (Chapter III) to be primarily interested in a realized concept of income.

There is also the possibility that employees may not consider income tax to be an expense. Any increase in wages to employees can be seen as being partially paid by a company through reduced income taxes. Employees would pay the income taxes applicable to their increased share of income (brought about by a wage increase) personally. Therefore employees, due to their interest in a realized concept of income, would want a flow-through method to be used in the calculation of income. This information would be of interest to employees for consideration of the amount of income tax currently paid by a corporation which could be applied to an increase in wages.

The General Public

The general public through their representatives in particular government agencies can conceivably dictate the specific accounting reports required by the agencies. Therefore a government agency could request accounting information to be classified in any way. The general public in a general way, though, are most likely to be interested

in a realized concept of income and a flow-through method for calculating income tax expense.

CONCLUSION

Chapter I set out the major conclusions which apply to this study. Here, these conclusions will be restated with particular reference to the body of the thesis. This presentation will help the reader understand more clearly the logic of the thesis.

Income tax is held to be an expense. Other classifications may be applicable, but due to the complexity of our present tax system this assumption is made.

As an expense, income tax can be treated like other expense items. Being a component of an income calculation, income tax assumes the assumptions of the particular calculation of income used. Different assumptions are applicable to different groups of people. Therefore different calculations of income and income tax can apply. The different calculations are presented in Chapter III (income) and Chapter IV (income tax).

Relevance to the readers of accounting statements is necessary in considering the measurement of income used. Shareholders, for example, are more interested in the emphasis of positive income producing items, but creditors are more interested in negative items. The different emphasis creates different income figures and different income tax calculations (see Chapters II and III).

Special purpose reports are probably required in other areas of accounting reports. This thesis has examined only income and one of its components, income tax, and found special calculations to apply to specialized groups. Other groups may be identified and other reports can be applicable to all groups.

The accounting profession must accept different criteria for evaluating and determining "generally accepted accounting principles." The logic currently utilized by the accounting profession is circular and restricted (see Chapter II). This thesis along with many other research projects

in accounting cannot be utilized by the profession until the criteria for evaluation is changed.

Accounting is currently used as information for decisions. External reports require greater emphasis on decision making processes. This thesis has outlined different measures of income and income tax which could apply to different groups of decision makers. The recommended measurements (in this thesis) of income and income tax are not currently acceptable to the profession. Prediction is assumed in most of the recommended measurements. If prediction is needed in decision making and accounting is an information source for decisions, then accountants should assume the role of prediction.

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